United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

74-2128

To be argued by
MICHAEL WEXELBAUM

United States Court of Appeals

FOR THE SECOND CIRCUIT

Docket No. 74-2128

In the Matter

—of—

MADERO SILKS, INC.,

Bankrupt.

PAULINE GREEN,

Claimant-Appellant,

—against—

MARY JOHNSON LOWE,

Trustee-Appellee.

BRIEF OF APPELLEE

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Preliminary Statement

This brief is submitted by Appellee ("Trustee") in support of the order of the Honorable Constance Baker Motley, Judge, dated June 28, 1974 and entered July 2, 1974, affirming the decision and order of the Honorable Edward J. Ryan, Referee in Bankruptcy, dated October 31, 1973, which granted Trustee's application to expunge the claim of Claimant-Appellant, Pauline Green ("Green") in the bankruptcy proceeding of Madero Silks, Inc. ("Madero").

Questions Presented

1) Was the Referee correct in finding that the claim for the $17,000.00 advanced to the bankrupt should be expunged as a contribution to capital?

2) Should the claim in question be subordinated to the claims of the other general unsecured creditors on equitable principles even if it is assumed that the claim is predicated upon a loan to the bankrupt?

Stipulation into Evidence

Pursuant to stipulation of counsel dated August 25, 1971, which has been filed with the Bankruptcy Court, the following have been deemed into evidence for the purposes of this proceeding:

1) The examinations of Pauline Green held July 16, 1969, July 30, 1969, and June 21, 1971;

2) The examination of George Centrella held June 25, 1970;

3) The Estimated Balance Sheet of the Bankrupt as at June 30, 1968 and Statement of Income and Expenses for the period January 1, 1968 to June 30, 1968, both prepared by Waxman, Pepper, Gotbetter & Company, Certified Public Accountants;

4) The Report of the examination of the books and records of the Bankrupt as at March 28, 1969 and the analysis thereof prepared for the Trustee by Joseph S. Herbert & Company, Certified Public Accountants.

Stipulation as to Facts

Pursuant to the aforesaid stipulation of counsel, the following facts are deemed established by the record:

1) That the Bankrupt corporation was organized January 27, 1959;

2) That the Bankrupt's records reflect that Carl Parisi became a shareholder of record on November 10, 1963, but that such ownership was nominal;

3) That on July 16, 1968 the Bankrupt received a check in the sum of $17,000.00 from Pauline Green, which check was deposited to the credit of the Bankrupt's bank account.

4) That the Bankrupt's books and records reflect an indebtedness of $17,000.00 to Pauline Green as a Loan Payable.

Footnote Key

Examination of Pauline Green	July 16, 1969	G-16
Examination of Pauline Green	July 30, 1969	G-30
Examination of Pauline Green	June 21, 1971	G-21
Examination of George Centrella	June 25, 1970	C-25
Transcript of testimony of Pauline Green at hearing on	Oct. 4, 1972	G-H4
Transcript of testimony of George Centrella at hearing on	Oct. 4, 1972	C-H4
Transcript of testimony of George Centrella at hearing on	Nov. 16, 1972	C-H16
Transcript of testimony of Ernest Roth at hearing on	Nov. 16, 1972	R-H16

Proceedings Below

Madero was adjudicated a bankrupt on March 18, 1969. Green filed a proof of claim in the amount of $17,000.00 on August 13, 1969. Before the Bankruptcy Court, the Trustee sought to have Green's claim expunged on the ground that it constituted a contribution to the capital of the bankrupt. Alternatively, the Trustee sought to have Green's claim subordinated to the claims of the other general unsecured creditors on equitable principles. As set forth above, Honorable Edward J. Ryan, Referee in Bankruptcy, ordered that Green's claim be expunged. Green appealed to the United States District Court for the Southern District of New York from said order of the Referee. Upon said appeal, Honorable Constance Baker Motley affirmed the Referee's decision and order, and Green appeals herein from the order of Judge Motley.

Facts

Madero was organized on January 27, 1959, by Ernest Roth ("Roth"), John Mayer ("Mayer"), and Sidney Derblich ("Derblich"). In 1963, Roth and Mayer were having difficulties, prompting Roth to go to George Centrella ("Centrella"), his life-long friend and former business associate, and ask for his help in getting Mayer out of the business (C-25, p. 3; C-H4, pp. 32 and 63-64). Centrella proceeded to arrange for his brother-in-law, Carl Parisi ("Parisi"), to acquire the stock of Mayer, Roth and Derblich in the corporation as a nominee (C-25, p. 6; C-H4, pp. 31-32). Madero's records indicate that Parisi became a shareholder of record on November 10, 1963 (Stipulation). Centrella has admitted that Parisi was in fact really his nominee (C-25, pp. 6-7; C-H4, pp. 31-32). Centrella also admits that at the time of the filing of the bankruptcy petition, all of the stock of the bankrupt was in Parisi's name (C-25, p. 9). However, Parisi took absolutely no part in the management of the business (C-25,

p. 9; C-H4, p. 31; R-H16, p. 9). On the contrary, he was apparently alternately active in the grocery business (C-25, p. 6; R-H16, pp. 9-10) and employed as a process server (C-H4, p. 31), and knew nothing about the intricacies of Madero's textile business (C-25, p. 9; R-H16, p. 10). However, Centrella, who was thoroughly familiar with and active in the textile industry, proceeded to play an extremely active role in Madero's management. As attested to by Green, Centrella and Roth, Centrella's advice and guidance was repeatedly sought and received by Roth, who remained as the president and titular chief operating officer of Madero. Green testified that Centrella was at Madero's place of business "sometimes . . . once a week, sometimes . . . every other day" (G-H4, p. 19) and that Roth and Centrella conferred "whenever a problem would come up" (G-H4, p. 19). Centrella testified that he would confer with Roth whenever his advice was sought (C-H16, pp. 4-5), and Roth verified that he often sought Centrella's advice (R-H16, p. 10). Although at the hearings before the Referee, both Centrella and Roth endeavored to convey the impression that Centrella's advice was of a general nature and only casually sought, Roth was compelled to admit that Centrella was a party to agreements pertaining to such intra-company matters as Roth's assumption of an insurance policy on his life held by Madero (R-H16, pp. 19-23), Roth's weekly salary (R-H16, pp. 23-24), and a proposed profit-sharing arrangement Roth was to participate in (R-H16, pp. 26-28). In addition, although Centrella at first claimed that he was made an authorized signatory of Madero's checks when the corporation was first formed in 1959, allegedly at the request of Derblich, who was afraid that Mayer and Roth "would be two against one" (C-H4, p. 53-54), it was clearly established at the hearings before the Referee that Centrella was first designated as an authorized signatory of Madero's checks on November 20, 1963, the time of the transfer of all of the stock to his nominee, Parisi (R-H16, pp. 15-17), and not prior to that time.

It is interesting to note that on p. 7 of Claimant-Appellant's brief, an attempt is made to perpetuate a blatant misstatement of fact first set forth by Centrella at the hearing before the Referee on October 4, 1972. Centrella stated that througout his years of association with Madero, he only signed one check, and that he signed that one check about January, 1969 just prior to the bankruptcy proceeding. When asked if he was absolutely sure of that fact, Centrella replied that he was "positive." Centrella was immediately forced to retract that statement, as two of Madero's checks bearing his signature, dated April 26, 1968 and May 16, 1968, were introduced into evidence as Trustee's Exhibits 8 and 9. It should be noted that the check dated May 16, 1968 was payable to the order of a company known as Tytex, Inc., of which Centrella is principal and president (C-H4, pp. 53-59).

In June, 1968, Madero was in financial trouble. There was very little cash available with which to pay current liabilities of greater than $120,000.00 and the corporation was operating at a loss (see Estimated Balance Sheet of June 30, 1968, and Statement of Income and Expenses for the period January 1, 1968 to June 30, 1968). In addition, the corporation had an overdraft with Mill Factors Corporation (C-25, p. 12; G-H4, p. 15; C-H4, pp. 59-60; R-H16, p. 29). According to the testimony of Green, Centrella and Roth, it was at this point that Centrella approached Green, an employee of Madero at that time, and arranged for her to "lend" Madero $17,000.00 (C-25, pp. 12-13; G-H4, pp. 14-17; C-H4, pp. 59-60; R-H16, pp. 28-32). On July 16, 1968, Madero received a $17,000.00 check from Green (Stipulation). At the time of bankruptcy, Madero's books and records carried an indebtedness of $17,000.00 to Green as a Loan Payable (Stipulation). However, this transaction was completely devoid of any indicia of a bona fide loan. The alleged loan was not evidenced by any promissory note or other written instrument (G-16, p. 14; G-21, p. 8; G-H4, pp. 11, 12; R-H16, p. 33). The check itself did not

contain any notation indicative of a loan transaction (G-21, pp. 9-10; G-H4, pp. 11-12, 13; R-H16, pp. 33-34). Madero did not give Green any collateral whatsoever (G-16, p. 15; G-21, p. 10; G-H4, p. 13; R-H16, pp. 34-35). The alleged loan did not have a fixed maturity date (G-16, p. 14; G-21, p. 8; G-H4, p. 10; R-H16, p. 35). No interest payments were ever made on the alleged loan (G-21, p. 10; G-H4, pp. 10-11, 13; R-H16, p. 35). In fact, Green never even asked for the payment of interest or the repayment of even a portion of the principal amount (G-16, p. 15; G-21, p. 10; G-H4, p. 14; R-H16, p. 35).

Throughout the proceedings in the Bankruptcy Court, the Claimant's position was that the $17,000.00 allegedly "loaned" to Madero was really Green's money. However, the record below clearly supports the Referee's finding that the alleged loan was in fact made by Centrella. Green and Centrella are extremely close, long-time friends. At a pre-trial examination, Centrella testified that he has been managing Green's financial affairs since 1965, the year Green's husband passed away (C-25; pp. 14-15). At the hearing before the Referee, Green testified that Centrella has been involved in the management of her financial affairs since shortly after her marriage, which took place in 1955, and that he had even gone so far as to open a brokerage account with Francis I. du Pont & Co. in her name (G-H4, pp. 20-23). Trustee's Exhibits "1 through 5" introduced into evidence at the hearing on October 4, 1972, establish that the account in question was opened on December 24, 1958 in the name of "Pauline Green c/o George Centrella." Upon being examined as to the nature and duration of his involvement with Green's financial affairs, Centrella vacillated and repeatedly contradicted himself as to whether he was merely a financial "adviser" to Green prior to the death of her husband, or an active manager of her financial affairs even prior to the death of her husband (C-H4, pp. 33-38), before being compelled to admit that he took an active part in the handling of her finances

at least from the time the brokerage account with Francis I. du Pont & Co. was opened in 1958 (C-H4, pp. 38-39). It is admitted by all concerned that so great was Green's trust in Centrella that she gave him complete control over her finances (G-16, p. 17; G-12, p. 15). Green's total reliance upon Centrella in all matters financial is further evidenced by the fact that Green's savings account was in Centrella's name as well as her own (C-H4, p. 40). Having been vested with complete discretion, Centrella proceeded to abuse this trust by commingling Green's funds with his own (G-16, pp. 17-18; G-21, p. 15; C-25, pp. 15-16, 23; C-H4; pp. 43, 47-48).

On the day before Green wrote the check for $17,000.00 to the order of the bankrupt, she deposited $17,000.00 into her checking account (G-16, p. 16). This deposit was given to her by Centrella (G-16, p. 17; G-30, p. 36; G-21, p. 15; G-H4, p. 20; C-H4, pp. 42, 44-46). Green has admitted that she has absolutely no idea as to the source of the funds (G-30, p. 41). At the time of this transaction, no money was withdrawn from any of Green's accounts by Centrella (G-30, p. 39). During the pre-trial examinations, Centrella was also unable to account for how he came to be holding $17,000.00 in cash of Green's money (C-25, pp. 14-23). However, at the hearing before the Referee, Centrella suddenly recalled that he borrowed the $17,000.00 in question from his sister, Viola Centrella, allegedly because he lacked the liquidity necessary for him to pay Green the $16,800.00 he claims he owed her at that time (C-H4, pp. 45-46). Centrella's testimony to the effect that his sister's check in the sum of $17,000.00 was probably payable directly to Green (C-H4, p. 46), directly contradicts his previous statement at the pre-trial examination that he gave Green his personal check in the sum of $17,000.00 to evidence that he was paying her a debt which he owed her (C-25, pp. 32-33). As noted by the Referee in his decision, Centrella testified that this $17,000.00 loan from his sister is interest free, remains

completely unrepaid, and is not evidenced by a promissory note or any other writing or record of any kind (C-H4, pp. 46-47).

As was also noted by the Referee, at the time Centrella allegedly advised and prevailed upon Green to lend $17,000.00 to a corporation that was admittedly in dire financial straits at the time, Green was subsisting on a salary of $30.00 per week plus social security benefits she is entitled to as a widow (G-H4, pp. 16, 25-26).

It must also be brought to the attention of the Court that although Centrella claims he kept a running record of all transactions he handled in Green's behalf (C-H4, pp. 42-43, 49-50) he was unable to produce any such records to verify or lend credence to his claim that at the time he gave Green the $17,000.00 in question he was indebted to her in the sum of $16,800.00, despite the fact that he "looked for" these all-important records (C-H4, p. 42). Centrella's testimony that he had only been able to find one of these record sheets, and that he had then subsequently lost that one sheet, certainly stretches the limits of credibility.

POINT I

The Referee's findings and conclusion that the claim for the $17,000.00 advanced to the bankrupt should be expunged as a contribution to capital were correct.

Bankruptcy Rule 810 provides that the findings of fact of a Referee in Bankruptcy may not be overruled unless they are "clearly erroneous". In addition, and of equal significance herein, Rule 810 also directs the District Court to "give due regard to the opportunity of the referee to judge the credibility of the witnesses". In the case at bar, the record clearly demonstrates that the underlying

findings of fact of the Referee were not clearly erroneous, and were in fact correct.

Pursuant to the authorities cited below, it is equally apparent that the Referee's principal finding of fact and conclusion of law, that the alleged "loan" to Madero was in fact a contribution to capital and should be expunged as such, is also unassailable, having been predicated upon the prevailing and incontrovertible underlying facts established in the Bankruptcy Court, and now apparently conceded upon appeal.

As was correctly determined by Judge Motley upon the initial appeal from the Referee's decision, "the facts and conclusions found by the Referee are adequately sustained by the hearing, documents and facts . . ." (Order of District Court).

An examination of the facts indicates that Centrella was the actual principal of Madero. While it is recognized that Parisi was the nominal shareholder of all of the stock in the corporation, it is evident that he was the nominee for Centrella. If Parisi acquired the stock of Mayer, Roth and Derblich in November, 1963 as the nominee for Roth, he would have eventually proceeded to transfer the stock over to Roth. However, Parisi never made any such transfer, and at the time of the filing of the petition in bankruptcy in 1969, more than five years later, all of the stock of Madero was still in Parisi's name. Obviously, he was acting on behalf of an outside party who wanted to remain anonymous. That party was Centrella.

It is also apparent that the $17,000.00 advanced to Madero really belonged to Centrella. It has been established that Centrella gave Green the $17,000.00 in question after having personally borrowed this money from his sister. Centrella testified that he had to borrow this money from his sister because he did not have the liquidity necessary

to otherwise give it to Green. As Centrella handled and had access to Green's accounts as well as his own, it is self-evident that neither of their accounts had a cash surplus of $17,000.00. Yet Centrella alleges that he borrowed this $17,000.00 to give to Green because he owed her $16,800.00 at the time. However, Centrella was completely unable to explain how he came to owe such a sum of money to Green, although he did testify that he completely commingled their accounts and transferred funds from one to the other. When asked to produce the records from which he had made his determination that he owed Green $16,800.00, Centrella testified that he had looked for them but could not find them.

It is imperative for this Court to keep in mind that throughout the proceedings in the Bankruptcy Court, Green and Centrella maintained that the alleged "loan" to Madero was made by Green, rather than Centrella, and vehemently denied that Centrella was the real principal of Madero. Upon appeal, a new tack is being taken. The decision and order of the Referee is being attacked solely on the grounds that the Referee misunderstood the applicable law. For purposes of appeal, the Claimant-Appellant is apparently conceding that Centrella was the real principal of Madero and that the $17,000.00 put at the disposal of Madero was in fact his money. The Claimant-Appellant would thus have this Court overlook the fraudulent and deceitful scheme by which Centrella sought to conceal the true facts and circumstances surrounding the transaction in question. This would not be proper, as the Referee's findings and conclusions must be reviewed with full regard to the factual setting before the Bankruptcy Court. The Referee's conclusion of law was predicated upon his findings that the transaction in question was devised by Centrella as a scheme by which he would enable himself to gain parity with the bona fide general unsecured creditors of Madero.

For the sake of argument, in the Trustee's trial memorandum, it was assumed that Parisi was the nominee of

Roth, and that the $17,000.00 advance belonged to Green. As the Court subsequently found that Centrella was the actual principal of Madero and the real owner of the $17,000.00, the arguments to follow carried even greater weight. However, they are applicable to either situation.

The Courts use varying indicia in an attempt to determine the true nature of a claimed loan transaction. These factors have varying degrees of relevancy, and are usually not all applicable to a given case.

In *Wood Preserving Corporation of Baltimore, Inc.* v. *United States*, 233 F. Supp. 600, 605 (D.C. Md. 1964), the Court stated:

> "The teaching of all of the cases is that no one characteristic is decisive in determining whether obligations are risk investments or debts . . . All of the factors which are present do not point in one direction; they seldom do, and a court must decide which are the most important factors under all of the circumstances."

An examination of the factors relevant to this case overwhelmingly indicates that the transaction in question created an equity interest in Madero and not a bona fide debtor-creditor relationship.

A bona fide debtor-creditor relationship is invariably evidenced by a written instrument of some sort. In holding that so-called debt was really equity, the Courts have relied heavily on the fact that no instrument evidencing a debt was ever issued. *Wood Preserving Corporation of Baltimore, Inc.* v. *United States, supra; Smith* v. *Commissioner of Internal Revenue*, 370 F.2d 178 (6th Cir. 1966). Green and Roth have testified that she was never given a promissory note or any other written debt instrument. In addi-

tion, the $17,000.00 check in question does not in any way indicate that a loan transaction existed wtih regard to these funds.

Two factors that may logically be considered together are the right to enforce the repayment of the principal and the payment of interest. A bona fide debtor-creditor relationship is usually predicated upon the periodic payment of interest and a fixed or ascertainable maturity date. *Wilbur Security Company* v. *Commissioner of Internal Revenue*, 279 F.2d 657 (9th Cir. 1960); *O.H. Kruse Grain and Milling* v. *Commissioner of Internal Revenue*, 279 F.2d 123 (9th Cir. 1960); *J.S. Biritz Construction Co.* v. *Commissioner of Internal Revenue*, 387 F.2d 451 (8th Cir. 1967). According to the testimony of both Green and Roth, this alleged loan had absolutely no fixed or even vaguely ascertainable maturity date. In addition, she never received nor asked for the payment of any interest on the alleged loan. It has been said that the existence of a fixed or ascertainable maturity date is generally the essential element of a creditor investment.

In *Fellinger* v. *United States*, 238 F. Supp. 67 (D.C. Ohio 1964), it was held:

> "The fact that ultimately there must be paid a definite sum at a fixed time marks the relationship to the corporation as that of a creditor rather than a shareholder. There must exist the right to demand payment unconditionally at a fixed time."

No such right existed in this case.

See also:

Curry v. *United States*, 396 F.2d 630 (5th Cir. 1968).

Another factor used by the Courts in determining whether a transaction such as the one in question created

a shareholder relationship or a debtor-creditor relationship is whether a bank or an astute outside investor would have made such a loan to the corporation. *Wood Preserving Corporation of Baltimore, Inc.* v. *United States, supra; Gilbert* v. *Commissioner of Internal Revenue,* 262 F.2d 512 (2d Cir. 1959); *J.S. Biritz Construction Co.* v. *Commissioner of Internal Revenue, supra; Wilbur Security Company* v. *Commissioner of Internal Revenue, supra; Fin Hay Realty Co.* v. *United States,* 398 F.2d 694 (3d Cir. 1968). An examination of the bankrupt's Balance Sheet of June 30, 1968 and Statement of Income and Expenses for the period January 1 to June 30, 1968, illustrates the fact that in view of its financial condition at that time, the bankrupt could not have obtained a similar loan from outside lending institutions. This conclusion is substantiated by the fact that the bankrupt had no bank loans outstanding at that time, while it was paying higher interest rates and charges on an overdraft with Mill Factors Corporation. (See Statement of Income and Expenses for January 1, 1968 to June 30, 1968). Obviously, the banks felt that Madero was a poor credit risk at the time of the transaction in question. Centrella substantiated this conclusion when he testified that it would have been impossible for Madero to obtain funds from any other financial institutions in view of its position with Mill Factors (C-H4, pp. 59-60).

The fact that the alleged creditor made no effort to collect the principal of the alleged loan has also been held by the Courts to be an indicia of a contribution to capital. *Wood Preserving Corporation of Baltimore, Inc.* v. *United States, supra; Gilbert* v. *Commissioner of Internal Revenue, supra.* It has even been suggested that "the character of indebtedness may vanish when the (parties) cease acting like debtors and creditors; perhaps that point is passed when the (lender), unlike the reasonable creditor, fails to force the (debtor) into bankruptcy." *Cayuna Realty Company* v. *United States,* 382 F.2d 298, 302 (Ct. Cl. 1967).

See also:

The Motel Company v. *Commissioner of Internal Revenue*, 340 F.2d 445 (2d Cir. 1965).

In the case at bar, Green has testified that she never even asked for the repayment of the alleged loan.

It should be noted that the Trustee realizes that no shares of stock or other instruments of ownership were ever issued to the alleged creditor. However, "the non-issuance of shares of stock . . . is not necessarily controlling in determining the character of the transaction . . ." *Foresun, Inc.* v. *Commissioner of Internal Revenue,* 348 F.2d 1006, 1009 (6th Cir. 1965). In a case such as this, where the indicia discussed above unanimously indicate that the transaction constituted a contribution to capital rather than a loan, the non-issuance of instruments of ownership should definitely not be determinative.

The foregoing discussion would be applicable to the case at bar even if the Referee had not found that Centrella was the actual shareholder of the bankrupt and the actual owner of the funds that were advanced. However, when the Referee found that Parisi was really the nominee for Centrella rather than for Roth, and that the funds advanced to Madero in fact belonged to Centrella rather than Green, then the conclusion that the claim should be expunged as a contribution to capital was unavoidable. The Courts view transactions such as the one in question with an even sterner eye when the alleged creditor is also a shareholder of the corporation. *Fin Hay Realty Co.* v. *United States, supra; Smith* v. *Commissioner of Internal Revenue, supra; Cuyuna Realty Company* v. *United States, supra; Wilbur Security Company* v. *Commissioner of Internal Revenue, supra.*

Point II of Claimant-Appellant's brief argues that "a loan to a corporation made or arranged by a person found to be in control thereof *may* be the basis of a valid claim in bankruptcy" (Emphasis ours). The Trustee has no argument with this contention. It is a fact. However, the Court must note that the operative word is "may." What the Claimant-Appellant fails to consider is that any such transactions between a principal and a corporation are subject to the closest scrutiny and held to the highest standards of fairness and good faith.

In *Pepper* v. *Litton,* 308 U.S. 295, 60 S. Ct. 238, 245, 84 L. Ed. 281 (1939), the Supreme Court stated:

> ". . . Their (stockholders) dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the . . . stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein."

Centrella has not met this burden. He is unable to do so, since this transaction was not entered into openly and in good faith, and it was inherently unfair from the viewpoint of the bankrupt's general unsecured creditors, as it was a surreptitious attempt by a silent shareholder to gain parity with the genuine creditors of the corporation for his infusion of capital into his failing business.

Claimant-Appellant's conclusion that "the Referee was of the opinion that no valid claim in bankruptcy may be made for loans or advances by person or persons in control of a corporate bankrupt . . . ." (pp. 12-13 of Claimant-Appellant's brief) has absolutely no basis in fact. As the record clearly shows, the Referee was merely complying with the Supreme Court mandate set forth in *Pepper* v.

Litton in presiding over and taking part in a vigorous and thorough examination of all of the circumstances surrounding the alleged loan to the corporation. After all of the evidence was presented, the Referee found that the claim in question was not entitled to the status of a bona fide debt of the bankrupt, regardless of the incontrovertible fact that a principal's legitimate loan to his corporation *may* constitute a valid claim in bankruptcy.

In the section from *Collier on Bankruptcy* quoted at length on p. 14 of the Claimant-Appellant's brief, the following language must be emphasized for the Court's attention:

> ". . . . They (the Courts) hold them (claims of shareholders) allowable where based on honest and bona fide dealings, but they expect the bona fides to be demonstrated beyond cavil and apply in their examination 'a large measure of watchful care.'" 3A *Collier on Bankruptcy* (14th Ed.), Sec. 63.06(5.3), p. 1789.

In addition, in quoting the aforesaid section from *Collier on Bankruptcy*, the Claimant-Appellant stops short, omitting a pertinent paragraph. The text continues:

> "The scope of the principle can, therefore, better be gauged by observing under what circumstances its application was denied, either by disallowing or by postponing claims of stockholders, directors or corporate officers. The exceptions are more informative than the rule. They cover a range of great variety, but if they are to be reduced to a common denominator it is probably safest to say that any actual or potential fraud upon creditors will result in disallowance or postponement. Fraud in this broad sense may assume various forms." 3A *Collier on Bankruptcy* (14th Ed.), Sec. 63.06(5.3), pp. 1792-1793.

Likewise, the refuge sought by Claimant-Appellant is not found in the dissenting opinion of Hon. Learned Hand, Circuit Judge, in *Gilbert* v. *Commissioner of Internal Revenue, supra,* which is quoted at length on pp. 13-14 of Claimant-Appellant's brief. As was noted by Judge Hand:

> ". . . some abuse of the shareholder's control must appear before his debt loses parity with other debts: . . ." *Gilbert* v. *Commissioner of Internal Revenue, supra* at 248 F.2d 410.

It is imperative that this Court note that the "latest decisions" referred to and cited by Judge Hand, in the quotation from the aforesaid dissenting opinion set forth in Claimant-Appellant's brief, all recognize, sanction and approve of the doctrine whereby claims of controlling persons of a corporation are carefully scrutinized and set aside in the interests of substantial justice whenever sham transactions are involved or the corporate insiders have abused their position of trust.

See:

Schwartz v. *Mills,* 192 F.2d 727, 729 (2d Cir. 1951);

Kraft Foods Company v. *Commissioner of Internal Revenue,* 232 F.2d 118, 125 (2d Cir. 1956);

Gannett Co. v. *Larry,* 221 F.2d 269 (2d Cir. 1955);

See also:

International Telephone and Telegraph Corporation v. *Holton,* 247 F.2d 178, 182-183 (4th Cir. 1957).

There is no doubt that the facts of this case establish an "actual or potential fraud upon creditors." Centrella concealed his identity as the actual owner of the bankrupt, and then labored to make it appear as though the alleged "loan" was made by Green. Now that his efforts on behalf

of the bankrupt have come to naught, he is attempting to establish parity with the general unsecured creditors of the bankrupt. The cases cited on p. 15 of Claimant-Appellant's brief all recognize the principle that a shareholder's claim may be expunged or subordinated in a situation such as that which prevails herein.

Claimant-Appellant has also failed to meet the test set forth in *Barlow* v. *Budge,* 127 F.2d 440 (8th Cir. 1942), as cited on p. 16 of Claimant-Appellant's brief. Centrella's surreptitious conduct was most definitely not "open, honest, and free from unfairness or fault." In addition, it cannot be said that the "loan" was made on terms beneficial to Madero's creditors (See p. 17 of Claimant-Appellant's brief), when it is realized that this influx of money should have initially gone on the company books as a contribution to capital by a shareholder, rather than as a loan.

Claimant-Appellant is misleading the Court when it states that the determination of whether an advance by an alleged creditor should be deemed to be a loan or a contribution to capital "depends on whether there was an original insufficiency of capital" (p. 20 of Claimant-Appellant's brief). This statement is misleading for two basic reasons.

In the first place, the "test" set forth in *Braddy* v. *Randolph,* 352 F.2d 80 (4th Cir. 1965), and cited on p. 20 of Claimant-Appellant's brief, is not the definitive test to be applied by a bankruptcy court in determining whether a "loan" should be deemed to be a contribution to capital. *Braddy* v. *Randolph* sets forth the "thin capitalization" theory. "Thin capitalization" is just one of many factors indicative of a contribution to capital, rather than a bona fide loan, and it is by no means controlling except in the absence of other relevant factors.

This very concept was recognized by the Court in *Rowan* v. *United States,* 219 F.2d 51 (5th Cir. 1955), which is cited on p. 21 of Claimant-Appellant's brief. Claimant-Appellant's reliance upon *Rowan* v. *United States* is misplaced, as once again the quoted excerpt omits pertinent language that follows. The Court continued, at 219 F.2d 55:

> "In what we have said we refer only to the situation where there is no evidence of an intent to make a contribution to capital other than the ratio between debt and stated capital. There are in this case none of the facts authorizing other inferences to be drawn, such as . . . subordination to other indebtedness; or inordinately postponed due date; or agreement not to enforce collection; or provision for payment of 'interest' only out of earnings; . . . one of which or a combination of which is present in the usual case of this type that comes before the appellate courts for consideration."

In *Braddy* v. *Randolph,* the "loans" were evidenced by written notes and secured by deeds of trust. In *Rowan* v. *United States,* the alleged loan was evidenced by a running account that fluctuated over the years and pursuant to which the principals claiming to be creditors were at times indebted to the bankrupt corporation. In each of these two cases, the transaction thus had some of the characteristics of a bona fide loan, and there was a dearth of the characteristics indicative of a contribution to capital. Therefore, the Court was forced to arrive at its decision with the "thin capitalization" theory as the only factor advanced in support of the contention that the alleged loan was in fact really a contribution to capital. However, it has been shown that none of the indicia of a bona fide loan are present in the case at bar. Therefore, the absence of "thin capitalization", if in fact it is absent in the case at bar, should in no way affect or offset the overwhelming weight of the preponderance of evidence indicative of a contribution to capital herein.

In addition, the "thin capitalization" theory is not always predicated upon an "initial insufficiency" of capital. This happened to be the case in *Braddy* v. *Randolph*. However, many cases have considered "thin capitalization" to be a relevant factor in determining that an alleged loan was really a capital contribution even though the initial capitalization of the corporation was sufficient. The Courts have indicated that whenever a corporation finds itself in the position of having a high debt-equity ratio, it may be deemed to be "thinly capitalized." Hence, "thin capitalization" can occur at any time during a corporation's existence, and it does not necessarily relate back to the corporation's inception.

See:

Wood Preserving Corporation of Baltimore, Inc. v. *United States, supra;*

Curry v. *United States, supra;*

J.S. Biritz Construction Co. v. *Commissioner of Internal Revenue, supra;*

Fin Hay Realty Co. v. *United States, supra.*

As set forth above, although the absence of "thin capitalization" in the case at bar would by no means be controlling herein, it should be noted by the Court that on June 30, 1968, only 2½ weeks before the alleged loan, Madero's debt-equity ratio stood at more than 6½-1 (see Estimated Balance Sheet on June 30, 1968, showing debt of $122,754.67 and equity of $18,407.81). Whether a debt-equity ratio of 6½-1 constitutes "thin capitalization" is not clear. The Courts have held that a debt-equity ratio of 2-1 does not constitute "thin capitalization" (*J.S. Biritz Construction Co.* v. *Commissioner of Internal Revenue, supra*), and that a debt-equity ratio of 25-1 does constitute "thin capitalization" (*The Motel Company* v. *Commissioner of Internal Revenue, supra*). The status of those debt-equity ratios

that fall between 2-1 and 25-1 is not well defined. Suffice to say that the ratio in a particular case should be considered in light of all of the other financial factors that are present therein. In the case at bar, it has been clearly established that Madero was in dire financial straits at the time of the debt-equity ratio of 6½-1. Hence, a finding that Madero was "thinly capitalized" at the time of the alleged loan is certainly reasonable. However, as already set forth above, in view of all of the other factors prevailing herein, the conclusion that the alleged loan was really a contribution to capital is warranted regardless of any determination on the question of "thin capitalizatiion," and the Court need not wrestle with this superfluous factor.

The underlying facts found by the Referee were not clearly erroneous, and were in fact manifestly correct. Hence, pursuant to Bankruptcy Rule 810 they must be accepted upon appeal, and it has thus been established that:

1) Centrella was the real principal of Madero;

2) The $17,000.00 allegedly "loaned" to Madero was Centrella's money, rather than Green's;

3) Centrella concealed his true identity as principal of Madero;

4) Centrella concealed his true identity as the party who put the $17,000.00 in question at the disposal of the bankrupt;

5) The transaction in question was a fraudulent scheme by which Centrella "intended to cause these funds to be put at the disposal of the corporation in an attempt to sustain it, intending that he could use Pauline Green as a cat's paw to salvage some part of his investment by way of a creditor's claim against any assets of the Corporation which might be available in insolvency" (Decision and order of Referee).

Pursuant to the underlying facts established at trial, as found by the Referee, it is respectfully submitted that the Referee's principal finding of fact and conclusion of law, that the alleged "loan" was really a contribution to capital by the principal of the corporation and thus should be expunged as such, is adequately sustained by the prevailing authorities. As set forth by the Court upon affirming the decision of the Referee in Bankruptcy expunging an alleged loan as a contribution to capital in *Braddy* v. *Randolph*, *supra* at 352 F.2d 82, 84:

> "Rather than invest more capital the officers and stockholders . . . substantially shifted and evaded the ordinary financial risks connected with this type of business enterprise and, at the same time, permitted the corporation to remain in a constant state of or in imminent danger of insolvency.
>
> ". . . the Court b ow was justified in concluding that . . . the . . . officers of the Bankrupt had not acted in good faith and for the best interests of the Bankrupt and its creditors. A court of bankruptcy is a court of equity which exercises broad equitable powers; it is empowered to 'sift the circumstances surrounding any claim to see that injustice or unfairness is not done in the administration of the bankrupt estate. And its duty to do so is especially clear when the claim seeking allowance accrues to the benefit of an officer, director or stockholder.' *Pepper* v. *Litton*, 308 U.S. 295, 308, 60 S. Ct. 238, 246, 84 L. Ed. 281 (1939). A sufficient basis for rejecting the claims of an officer, director, or stockholder may be simply the violation of the rules of fair play and good conscience or a breach of the standards of conduct which an officer or director in his fiduciary capacity owes the corporation, its stockholders and creditors."

POINT II

Even if it is assumed that the claim is predicated upon a loan to the bankrupt, it should be subordinated to the claims of the other general unsecured creditors on equitable principles.

In the event that the Court is unable to concur with the Referee's finding and conclusion that the advance in question was a contribution to the capital of the bankrupt rather than a loan, it should proceed to subordinate the claim to the claims of the other general unsecured creditors as a matter of equity. It is self-evident from the Referee's decision that had he been unable to find that the alleged loan was really a capital contribution, he would have subordinated the claim on equitable principles in light of the "deceit, dishonesty and fraud" perpetrated herein. The Referee emphatically stated that Centrella "is entitled to no aid from this court of equity" (Decision and order of Referee).

In *Bank of America National Trust & Savings Association* v. *Erickson*, 117 F.2d 796, 798 (9th Cir. 1941), the Court stated:

> "The bankruptcy court has undoubted power to subordinate a general claim to other claims in the same category where for any reason, legal or equitable, it ought to be subordinated."

See also:

Taylor v. *Standard Gas Co.*, 306 U.S. 307, 59 S. Ct. 543, 83 L. Ed. 669 (1939);

Costello v. *Fazio*, 256 F.2d 903 (9th Cir. 1958).

The equitable doctrine of subordination as it is applied in the Bankruptcy Courts has been defined as follows:

> "With the facts established, we return to *Pepper* v. *Litton* and its rules of law. That case . . . held that

> in bankruptcy the claim of a dominant stockholder must be carefully scrutinized, since he is a fiduciary as to minority stockholders and creditors. . . .
>
> . . . If the claim of a dominant stockholder arises from some transaction with the corporation, it may be subordinated, if some inequity on his part is shown. . . .
>
> . . . 'He who comes into equity must come with clean hands. . . .' It is this maxim . . . which is embodied in the doctrine of *Pepper* v. *Litton*. He who comes into a court of bankruptcy (into equity) must not come to enforce a claim at the expense of creditors which he has acquired in breach of a fiduciary obligation he owed to creditors (his hands are not clean)." *In Re Kansas City Journal-Post Co.*, 51 F. Supp. 1009, 1013-1015 (W.D. Mo. 1943) aff'd. 144 F.2d 791 (8th Cir. 1944).

Equity often requires that a claim of a creditor be subordinated to the claims of other general creditors when the creditor in question is closely associated with the bankrupt. This is especially true "in corporate bankruptcies, where the Courts carefully scrutinize the claims of all who might stand in the relation of alter ego, co-adventurer, or owner of the corporate bankrupt." 3A *Collier on Bankruptcy* (14th Ed.) Sec. 65.06, p. 2292. The actual "creditor" behind this claim is Centrella. He handled all of Green's financial affairs. Centrella has testified that he was extremely careful with Green's money (C-25, p. 23). Yet he would like to have the Court believe that he advised Green to lend $17,000.00 of her savings to Madero at a time when it was a very poor credit risk. The alleged loan was supposedly based solely upon Centrella's close friendship with Roth (C-25, pp. 13-14). Centrella has admitted that he was not very careful with regard to the alleged loan (C-25, p. 24). It is extremely unlikely that one entrusted with discretionary management of another's financial affairs

would proceed to make such a careless, dangerous loan. Rather, it is much more likely that Centrella advanced the money to Madero out of his own funds. Such a loan is understandable only when predicated upon Centrella's close personal and business relationship with Roth and the bankrupt. The conclusion that the money advanced to Madero really belonged to Centrella is further supported by the evidence indicating that Centrella was in fact the actual owner of Madero. Under these circumstances, it would be unconscionable to permit the limited assets of Madero to be diminished by the uninhibited allowance of this claim. Having perpetuated a fraudulent scheme, whereby he concealed his true identity as the actual principal of Madero and real owner of the funds put at the corporation's disposal, Centrella does not come into court with clean hands.

As was stated by the Court of Appeals of the 8th Circuit prior to its consideration of the question of whether a claim of a principal of a bankrupt should have been allowed or expunged as a contribution to capital:

> "We should say at the outset that anything that may be owing to Boyum on his note claims will be ordered subordinated to the payment of the other general creditors. The record shows that the bankrupt was essentially a one-man corporation. Boyum was the controlling shareholder and virtually ran the affairs of the corporation on his own. His general dealings with the corporation were not on the arm's length plane of the other creditors. The cash advances which he made were apparently necessary to supply a deficiency in working capital . . . they were . . . part of a plan of permanent, personal financing, to avoid the necessity of increasing the capital of the corporation. Boyum's note claims, therefore, cannot be said to occupy an equal equitable position with the other general claims and should accordingly be subordinated to them." *Boyum* v. *Johnson,* 127 F.2d 491, 494 (8th Cir. 1942).

Furthermore, the principles of equitable subordination should apply even if the Court finds that Green is the actual "creditor" behind this claim. Green was closely associated with the bankrupt both as an employee and through her personal friendship with Roth. The evidence introduced at trial clearly shows that she did not expect any part of this alleged loan to be repaid until and unless Madero started to operate profitably. Thus, Green must be considered a co-adventurer rather than a bona fide creditor, and her claim should not be treated equally with those of the other general unsecured creditors.

In 3A *Collier on Bankruptcy* (14th Ed.), Sec. 63.08, pp. 1825-1826, the following appears:

> ". . . a claim may be provable and on principle also allowable, and yet due to circumstances surrounding its origin it may appear unfair to allow the claim to compete with those of other creditors on a footing of equality. *The claimant's conduct . . . may warrant the inference that his investment, though legally a credit, was economically more in the nature of a partnership or similar commercial venture more or less identifying the claimant with the bankrupt,* or it may be *tainted with some degree of fraud, deceit, or other objectionable practice.* Under these and comparable circumstances, the *claimant should not,* through a straight allowance, *be permitted to increase the loss already suffered by other creditors,* while on the other hand the facts may not be sufficient to justify complete disallowance. The compromise as worked out by judicial practice is a mode of relative disallowance, the judge-made counterpart to the priorities provided by the Act, and is usually called 'postponement' or *'subordination'*. It is *one of the valuable contributions of equity to the body of statutory bankruptcy law"* (Emphasis ours).

Regardless of the ultimate determination of the Court as to who the money allegedly loaned to the bankrupt really belonged to, the claim in question cannot be said to occupy an equal equitable position with the other general unsecured claims. Therefore, it should be subordinated to them in order to prevent the consummation of a course of conduct which would be completely inequitable and prejudicial to the other general unsecured creditors. There can be no doubt that the Referee would have subordinated the claim in question had he been unable to conclude that it was in fact a contribution to capital that should be completely expunged. This Court should give due regard to the Referee's findings as the trier of fact.

> "We think that the duty and responsibility of determining whether, under the applicable law, the claim of Budge was upon an equitable parity with the claims of other creditors was primarily that of the bankruptcy court, which was charged with the administration of this insolvent estate, and that this Court would not be justified in setting aside the order appealed from unless convinced that it was clearly erroneous. We are not convinced that it was clearly erroneous." *Barlow* v. *Budge*, *supra* at 127 F.2d 444.

CONCLUSION

The order of the Honorable Constance Baker Motley, dated June 28, 1974, and entered July 2, 1974, affirming the decision and order of Honorable Edward J. Ryan, dated October 31, 1973, should be affirmed, with costs and counsel fees.

Respectfully submitted,

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United States Court of Appeals
FOR THE SECOND CIRCUIT

No. 74-2128

In The Matter of

MADERO SUITS, INC.

Bankrupt.

- - - - - - - -

PAULINE GREEN

Claimant-Appellant

v.

MARY JOHNSON LOWE

Trustee-Appellee

AFFIDAVIT OF SERVICE BY MAIL

Albert Sensale, being duly sworn, deposes and says, that deponent is not a party to the action, is over 18 years of age and resides at 914 Brooklyn Ave Brooklyn, N.Y.

That on the 21st day of October, 1974, deponent served the within B. for the Appellee upon Kaplan & Abrahams, P.C. 200 Garden City Plaza Garden City, N.Y. 11530

Attorney(s) for the Appellant in the action, the address designated by said attorney(s) for the purpose by depositing a true copy of same enclosed in a postpaid properly addressed wrapper, in a post office official depository under the exclusive care and custody of the United States Post Office department within the State of New York.

Albert Sensale

Sworn to before me,

This 21st day of October 1974

William A. McKaraney

WILLIAM A. McKARANEY
Notary Public, State of New York
No. 41-7048700
Qualified in Queens County
Certificate filed in Kings County
Commission Expires March 30, 1976